

December 15, 2010

Attention: Sir David Tweedie

Chair, International Accounting Standards Board 30 Cannon Street London EC4M6XH United Kingdom

Dear Sir:

Re: Exposure Draft, Leases

The Canadian Electricity Association (CEA) is the leading voice for the electricity sector in Canada. CEA members represent approximately 90 percent of all generation, transmission, distribution and marketing of electricity in Canada, as well as leading manufacturers and suppliers to the industry. The CEA's Accounting and Finance Committee, which includes more than 25 representatives from some of the largest member organizations, has reviewed the Exposure Draft (ED), Adoption of IFRSs by Entities with Rate-regulated Activities.

The CEA appreciates the opportunity to provide comments on the ED to the IASB.

Question 1: Lessees

- (a) Do you agree that a lessee should recognise a right-of-use asset and a liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?
- (b) Do you agree that a lessee should recognise amortisation of the right-of-use asset and interest on the liability to make lease payments? Why or why not? If not, what alternative model would you propose and why?

Response:

- (a) We agree that a lessee should recognize a right-of-use asset and a liability to make lease payments, as recognizing the liability allows the commitments and the corresponding assets to be recognized on the balance sheet. However, we have concerns around the measurement of the lease assets and liabilities beyond the minimum lease terms. These concerns are discussed further in our responses to questions 8 and 9.
- (b) We agree that a lessee should amortize the right-of-use asset and accrete the liability to make lease payments. We recognize that using IAS 38 and IAS 37 to amortize the asset and accrete the liability maintains consistency with existing IFRSs. However, using the effective interest rate method front loads the expense which may have a significant impact when the simplified retrospective approach is applied in year one of the new lease standard.

Question 2: Lessors

- (a) Do you agree that a lessor should apply:
 - (i) the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected lease term, and;
 - (ii) the derecognition approach otherwise?

Why or why not? If not, what alternative approach would you propose and why?

(b) Do you agree with the boards' proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting?

Why or why not? If not, what alternative model would you propose and why?

Response:

- (a)(i) We disagree that the lessor should apply the performance obligation approach if the lessor retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term.
- (a)(ii) We believe that the derecognition approach mirrors the lessee accounting and therefore should be applied in preference to the performance obligation method.
- (b) We disagree with the board's proposals for the recognition of assets, liabilities, income and expenses for the performance obligation and derecognition approaches to lessor accounting. Although we agree with using the present value of the lease payments for the right to receive asset, we have some issues with the expected term and contingent lease payments outside of the minimum lease term which are discussed in our responses to questions 8 and 9.

Question 3: Short-term leases

The exposure draft proposes that a lessee or a lessor may apply the following simplified requirements to short-term leases, defined in Appendix A as leases for which the maximum possible lease term, including options to renew or extend, is twelve months or less:

- (a) At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently,
 - (i) the liability to make lease payments at the undiscounted amount of the lease payments and:
 - (ii) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees would recognize lease payments in profit or loss over the lease term (paragraph 64).
- (b) At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets and liabilities arising from a shortterm lease in the statement of financial position, nor derecognize any portion of the



underlying asset. Such lessors would continue to recognise the underlying asset in accordance with other IFRSs and would recognize lease payments in profit or loss over the lease term (paragraph 65). (See also paragraphs BC41–BC46.)

Do you agree that a lessee or a lessor should account for short-term leases in this way? Why or why not? If not, what alternative approach would you propose and why?

Response:

We agree that a lessee or a lessor should account for short-term leases through the simplifications offered through short-term lease accounting.

Definition of a lease

The exposure draft proposes to define a lease as a contract in which the right to use a specified asset or assets is conveyed, for a period of time, in exchange for consideration (Appendix A, paragraphs B1–B4 and BC29–BC32). The exposure draft also proposes guidance on distinguishing between a lease and a contract that represents a purchase or sale (paragraphs 8, B9, B10 and BC59–BC62) and on distinguishing a lease from a service contract (paragraphs B1–B4 and BC29–BC32).

Question 4

- (a) Do you agree that a lease is defined appropriately? Why or why not? If not, what alternative definition would you propose and why?
- (b) Do you agree with the criteria in paragraphs B9 and B10 for distinguishing a lease from a contract that represents a purchase or sale? Why or why not? If not, what alternative criteria would you propose and why?
- (c) Do you think that the guidance in paragraphs B1–B4 for distinguishing leases from service contracts is sufficient? Why or why not? If not, what additional guidance do you think is necessary and why?

Response:

- a) We do not believe that a lease is defined appropriately. The existing IFRIC 4 on which the definitions and guidance are based is not always clear with respect to the distinction between service contracts and lease agreements. The criteria for distinguishing between leases and service contracts will replace the bright lines with respect to operating versus finance leases in the quest to keep leases off the balance sheet. More guidance is required to improve the distinction given in IFRIC 4 to prevent leases from being pushed down the service contract route.
- b) We believe that there are inconsistencies between the revenue recognition in the lease ED and the revenue recognition ED which need to be addressed. The sale of an asset within a lease should either be accounted for as a lease until the purchase option is exercised, or the revenue recognition ED should be applied.



c) No, see our response to (a).

Question 5: Scope exclusions

The exposure draft proposes that a lessee or a lessor should apply the proposed IFRS to all leases, including leases of right-of-use assets in a sublease, except leases of intangible assets, leases of biological assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources (paragraphs 5 and BC33–BC46).

Do you agree with the proposed scope of the proposed IFRS? Why or why not? If not, what alternative scope would you propose and why?

Response:

We agree with the proposed scope of the proposed IFRS. However, we believe that intangible assets need to be addressed through a review of IAS 38.

Question 6: Contracts that contain service components and lease components

The exposure draft proposes that lessees and lessors should apply the proposals in Revenue from Contracts with Customers to a distinct service component of a contract that contains service components and lease components (paragraphs 6, B5–B8 and BC47–BC54). If the service component in a contract that contains service components and lease components is not distinct:

- (a) the FASB proposes the lessee and lessor should apply the lease accounting requirements to the combined contract.
- (b) the IASB proposes that:
 - (i) a lessee should apply the lease accounting requirements to the combined contract.
 - (ii) a lessor that applies the performance obligation approach should apply the lease accounting requirements to the combined contract.
 - (iii) a lessor that applies the derecognition approach should account for the lease component in accordance with the lease requirements, and the service component in accordance with the proposals in Revenue from Contracts with Customers.

Do you agree with either approach to accounting for leases that contain service and lease components? Why or why not? If not, how would you account for contracts that contain both service and lease components and why?

Response:

We disagree with either approach for accounting for leases that contain both service and lease components. To provide relevant financial reporting which reflects the economic reality of transactions, the lease and the service elements should be separated. The guidelines around this distinction will need to be



robust to help the practical considerations faced by preparers. Our favoured approach is the IASB's; where a derecognition approach has been chosen, then the lease and service elements should be identifiable, allowing them to be separated and accounted for separately. Where they cannot be separated, we suggest that a service contract approach is used rather than the lease approach.

Question 7: Purchase options

The exposure draft proposes that a lease contract should be considered as terminated when an option to purchase the underlying asset is exercised. Thus, a contract would be accounted for as a purchase (by the lessee) and a sale (by the lessor) when the purchase option is exercised (paragraphs 8, BC63 and BC64).

Do you agree that a lessee or a lessor should account for purchase options only when they are exercised? Why or why not? If not, how do you think that a lessee or a lessor should account for purchase options and why?

Response:

We agree that a lease should be considered as terminated when an option to purchase the underlying asset is exercised.

As discussed in 4 (b), there needs to be either consistency with the revenue recognition ED or the purchase option should be within the scope of the lease ED.

There are also inconsistencies between the expected term of the lease and the recognition of a purchase only when an option is exercised. We believe that the principles in IAS 17 around recognising a lease as a finance lease reflecting the sale/purchase of an asset is more in line with reflecting the true economic substance of the transaction.

Question 8: Lease term

Do you agree that a lessee or a lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease? Why or why not? If not, how do you propose that a lessee or a lessor should determine the lease term and why?

Response:

We disagree that the lessee or lessor should determine the lease term as the longest possible term that is more likely than not to occur taking into account the effect of any options to extend or terminate the lease. An expected lease term is very difficult to estimate reliably. Considering renewal options creates subjectivity which is likely to change on an annual basis and does not reflect the economic reality of management's decisions. An asset is leased to provide



flexibility and assist with cash flow requirements, etc. We do not believe that an option can substantiate an asset and liability as it is avoidable.

In the absence of evidence to the contrary, it would be more useful to the reader to recognise an asset and a liability based on the minimum (actual) lease term as well as being more consistent with the conceptual framework. This would also reflect the actual cash commitments that the lease creates.

There is a fine line between providing useful information to the reader and providing commercially sensitive information to the lessor. Disclosing an expected lease term will alert the lessor to the lessee's intentions, which would put the lessor in a stronger position at renewal negotiations.

The minimum lease payments are more relevant when considering the cash flow, liquidity and going concern. Where a lease is cancellable, the obligation does not exist. Using the minimum lease term also has the advantage of removing some of the subjectivity in the ED.

From the lessors' point of view, recognising a right to receive asset based on longest expected term is not consistent with the framework as the option to renew is in the hands of the lessee, not the lessor. Therefore, the lessor does not have control.

Our proposed alternative is to use a minimum lease term rather than the longest possible term that is more likely than not to occur.

Question 9: Lease payments

Do you agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specified in the lease should be included in the measurement of assets and liabilities arising from a lease using an expected outcome technique? Why or why not? If not, how do you propose that a lessee or a lessor should account for contingent rentals and expected payments under term option penalties and residual value guarantees and why?

Do you agree that lessors should only include contingent rentals and expected payments under term option penalties and residual value guarantees in the measurement of the right to receive lease payments if they can be measured reliably? Why or why not?

Response:

We agree that contingent rentals and expected payments under term option penalties and residual value guarantees that are specific in the lease should be included in the measurement of assets and liability arising from a lease using an



expected outcome technique. However, in line with our views on the expected lease term, we do not believe that contingent lease payments beyond the minimum lease term should be included in the calculation.

Management's best estimate of contingent rents within the minimum lease term are more likely to be accurate than estimates over the expected term of the lease, which takes away the need for complex expected outcome calculations.

For lessors, it is less likely that they can reliably measure the lessee's contingent rental which raises a question around the measurement of the right to receive asset.

Question 10: Reassessment

Do you agree that lessees and lessors should remeasure assets and liabilities arising under a lease when changes in facts or circumstances indicate that there is a significant change in the liability to make lease payments or in the right to receive lease payments arising from changes in the lease term or contingent payments (including expected payments under term option penalties and residual value guarantees) since the previous reporting period? Why or why not?

If not, what other basis would you propose for reassessment and why?

Response:

As discussed above, we are of the opinion that only the minimum lease term should be considered. This would reduce the requirement to revalue the assets and liabilities from leases. We agree that only where there is <u>significant change</u> should the assets and liabilities be revalued. We are of the opinion that any change to the lease liability and asset should impact the value of the residual asset when applying the derecognition method for lessors. Ignoring the residual asset is inconsistent with the valuation at the inception of the lease.

Sale and leaseback

The exposure draft proposes that a transaction should be treated as a sale and leaseback transaction only if the transfer meets the conditions for a sale of the underlying asset and proposes to use the same criteria for a sale as those used to distinguish between purchases or sales and leases. If the contract represents the sale of the underlying asset, the leaseback would also meet the definition of a lease, rather than a repurchase of the underlying asset by the lessee (paragraphs 66–67, B31 and BC160–BC167).

Question 11

Do you agree with the criteria for classification as a sale and leaseback transaction? Why or why not? If not, what alternative criteria would you propose and why?



Response:

We agree with the criteria for classification as a sale and lease back. However, we do not agree with using the performance obligation method for lessor accounting. While the lessor might have bought the asset, transferring the control to the lessor, the lessee has the right to use the asset during the lease term. Therefore, the lessor should derecognise a portion of the asset to reflect the lessee's right to use the asset. The motivation for the seller is not usually to lose control of the asset it has sold, but to aid cash flow. The substance of the transaction is usually that the seller will continue to use the asset as it did before the sale. Therefore, we are of the opinion that the derecognition approach is more appropriate for the lessor in a sale and lease back transaction and that the lessor should derecognise a portion of the asset representing the lessee's use of the asset. The lessor should derecognise the portion leased to the lessee, as the lessee is continuing to use the asset as they did before the sale. Using the performance obligation approach would result in recognition of an asset in both the lessee and lessor's books.

Presentation

The exposure draft proposes that lessees and lessors should present the assets, liabilities, income (or revenue), expenses and cash flows arising from leases separately from other assets, liabilities, income, expenses and cash flows (paragraphs 25–27, 42–45, 60–63 and BC142–BC159).

Question 12: Statement of financial position

(a) Do you agree that a lessee should present liabilities to make lease payments separately from other financial liabilities and should present right-of-use assets as if they were tangible assets within property, plant and equipment or investment property as appropriate, but separately from assets that the lessee does not lease (paragraphs 25 and BC143–BC145)?

Why or why not? If not, do you think that a lessee should disclose this information in the notes instead? What alternative presentation do you propose and why?

- (b) Do you agree that a lessor applying the performance obligation approach should present underlying assets, rights to receive lease payments and lease liabilities gross in the statement of financial position, totaling to a net lease asset or lease liability (paragraphs 42, BC148 and BC149)? Why or why not? If not, do you think that a lessor should disclose this information in the notes instead? What alternative presentation do you propose and why?
- (c) Do you agree that a lessor applying the derecognition approach should present rights to receive lease payments separately from other financial assets and should present residual assets separately within property, plant and equipment (paragraphs 60, BC154 and BC155)? Why or why not? Do you think that a lessor should disclose



- this information in the notes instead? What alternative presentation do you propose and why?
- (d) Do you agree that lessors should distinguish assets and liabilities that arise under a sublease in the statement of financial position (paragraphs 43, 60, BC150 and BC156)? Why or why not? If not, do you think that an intermediate lessor should disclose this information in the notes instead?

Response:

We agree that lease assets which have different characteristics, rights and expectations of future cash flows to other assets recognised under the framework and IFRS, should be disclosed separately in the notes to the financial statements. The option should be provided for companies to either disclose separately on the face of the statements or in the notes. This would prevent companies which do not have significant leases having to disclose on the face of the statements, taking attention away from their core operations.

Question 13: Statement of comprehensive income

Do you think that lessees and lessors should present lease income and lease expense separately from other income and expense in profit or loss (paragraphs 26, 44, 61, 62, BC146, BC151, BC152, BC157 and BC158)? Why or why not? If not, do you think that a lessee should disclose that information in the notes instead? Why or why not?

Response:

We agree that lease assets which have different characteristics, rights and expectations of future cash flows to other assets recognised under the framework and IFRS, should be disclosed separately in the notes to the financial statements. The option should be provided for companies to either disclose separately on the face of the statements or in the notes. This would prevent companies which do not have significant leases having to disclose on the face of the statements, taking attention away from their core operations.

Question 14: Statement of cash flows

Do you think that cash flows arising from leases should be presented in the statement of cash flows separately from other cash flows (paragraphs 27, 45, 63, BC147, BC153 and BC159)? Why or why not? If not, do you think that a lessee or a lessor should disclose this information in the notes instead? Why or why not?

Response:

We agree that lease assets which have different characteristics, rights and expectations of future cash flows to other assets recognised under the framework and IFRS, should be disclosed separately in the notes to the financial statements. The option should be provided for companies to either disclose separately on the face of the statements or in the notes. This would prevent



companies which do not have significant leases having to disclose on the face of the statements, taking attention away from their core operations.

Disclosure

Question 15

Do you agree that lessees and lessors should disclose quantitative and qualitative information that:

- (a) identifies and explains the amounts recognised in the financial statements arising from leases; and
- (b) describes how leases may affect the amount, timing and uncertainty of the entity's future cash flows (paragraphs 70–86 and BC168–BC183)? Why or why not? If not, how would you amend the objectives and why?

Response:

We agree that thorough disclosure is required given the complexities and estimates involved in applying the ED. If our proposal of considering only the minimum lease period was applied, this would reduce the assumptions to be disclosed. It would be useful for the IASB to provide direction on how such information could be aggregated to ensure that it provides useful information without overwhelming the reader with high volumes of disclosure.

Transition Question 16

- (a) The exposure draft proposes that lessees and lessors should recognise and measure all outstanding leases as of the date of initial application using a simplified retrospective approach (paragraphs 88–96 and BC186–BC199). Are these proposals appropriate? Why or why not? If not, what transitional requirements do you propose and why?
- (b) Do you think full retrospective application of lease accounting requirements should be permitted? Why or why not?
- (c) Are there any additional transitional issues the boards need to consider? If yes, which ones and why?

Response:

- a) We agree that lessees and lessors should recognize and measure all outstanding leases as of the date of initial application using a simplified retrospective approach.
- b) We agree that full retrospective application should be permitted. To be cost effective we expect that most entities will choose the simplified version, however, for entities with significant leases, full retrospective application may better reflect the cycles of the leases.
- c) We would like to see more guidance on how sale and leaseback and purchase in substance transactions should be treated on transition.



Benefits and costs

Question 17

Paragraphs BC200–BC205 set out the boards' assessment of the costs and benefits of the proposed requirements. Do you agree with the boards' assessment that the benefits of the proposals would outweigh the costs? Why or why not?

Response:

We disagree with the boards' assessment that the benefits of the proposals would outweigh the costs, due to the fact that the complexities and estimates reduce the benefits to the reader. We agree that recognising an asset and liability on the balance sheet within the minimum lease term is consistent with the conceptual framework. However, trying to recognise assets and liabilities beyond the minimum lease term is where the cost of application increases compared to its benefits, resulting in a decreased understanding to the reader. The cost of educating the users and preparers, as well as the additional systems and management time spent reviewing estimates will, in our opinion, outweigh the benefit of applying the ED in its entirety.

We also do not believe that applying the ED as it stands would improve the financial statements. The amount of assumptions, subjectivity and complex calculations would take the focus away from the cash commitments a lease creates and its impact on an entity's liquidity.

Should you have any questions or require any additional information about our comments, please contact Mike Olson, Chair of the Accounting & Finance Committee. Mike may be contacted as follows:

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Sincerely,

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President and Chief Executive Officer

